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AGENDA ITEM 12b

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Report on China

II. PROGRAM: CalPERS Total Fund

III. RECOMMENDATION: Informational Item

IV. ANALYSIS:

Over the period October 31-November 12, 2005, CalPERS Board Members Robert Carlson, Priya Mathur, Kurato Shimada and CalPERS Staff members Mark Anson, Michael McCook, Peter Mixon and Leon Shahinian traveled to China. CalPERS Board and Staff members were joined by members of other pension funds, representatives of the Pacific Pension Institute and also a representative of SEIU, Marguerritte Young. Over 12 days, the group visited Hong Kong, Shanghai, Hangzhou, and Beijing.

Meetings were held each day with Chinese Government officials, local on the ground investors, CalPERS' Investment partners, and local business people to gain a perspective on the economic growth of China. China is indeed a country of contrasts: A capitalist economy with a Communist government; Ultra-modern cities along the Pacific coast to an agriculture economy in the interior of the country; Street-smart investors competing with corrupt local government officials—the contrasts are endless.

Below, we have summarized the main points of investing in China. For ease of digestion, we have broken down our report by asset class. In addition we have included a review on the developing legal infrastructure in China.

Global Equity Perspective on China

State Owned Enterprises

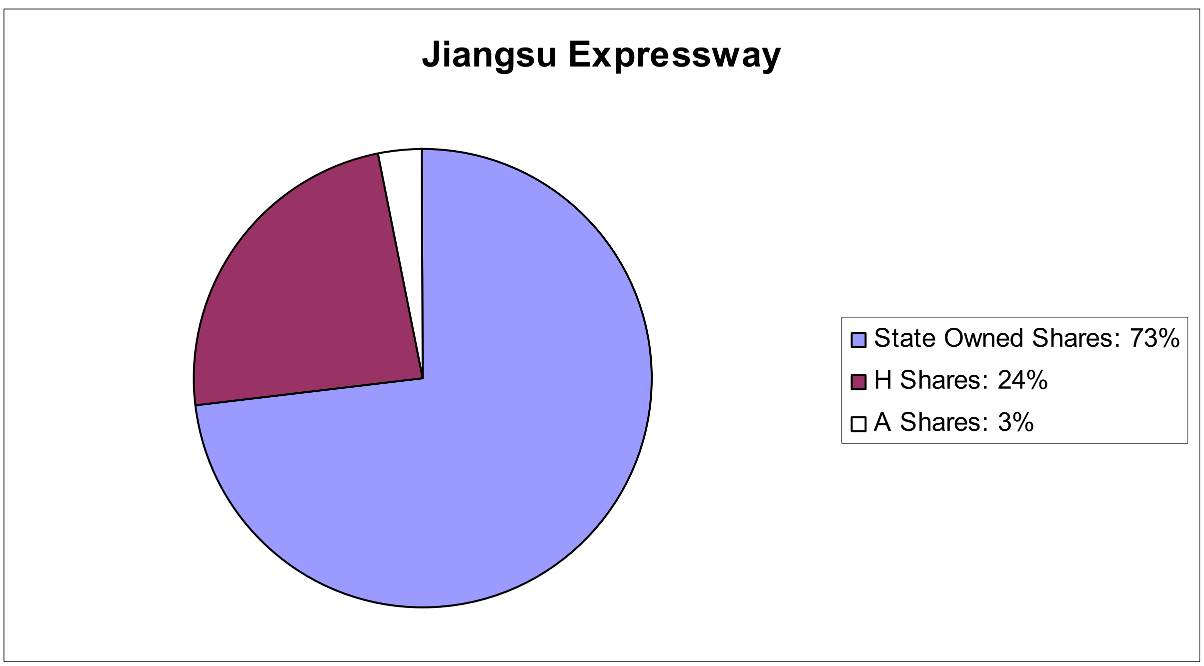
China is a country with most operating companies owned by the Communist Government. These are referred to as State Owned Enterprises (SOEs).

Currently, a single SOE can have several classes of equity shares:

- **Legal Person Shares**: Shares owned by the Government or Government sponsored entities; these shares are un-Listed.
- **A Shares**: Listed Shares in China owned by Chinese investors.
- **B Shares**: Listed Shares in China owned by foreign residents in China.
- **H Shares**: Shares listed on the Hong Kong Stock Exchange.
- **N Shares**: Shares listed on stock exchanges outside China (e.g. the NYSE).

  The sheer number of shareowner classes raises governance issues for SOEs.
- Also, valuations differ among the different classes of shares.
- For example, A shares typically trade at a higher P/E multiple than B shares.

  Case Example: Jiangsu Expressway Company Ownership structure:
- State Owned or Controlled Legal Shares: 73%
- H Shares: 24%
- A Shares: 3%



The Jiangsu Expressway Company is typical of many SOEs in that approximately 70% of the equity is owned by the State in non-Listed stock.

Sale of Government's Stake in SOEs

As China moves forward on its capitalist program, many of the SOEs will be converted to private ownership.
- There are 1,400 SOEs that have their stock listed in A shares on domestic exchanges.

- The China Securities Regulatory Commission (CSRC) plans to bring to the market an estimated $250 billion overhang of un-listed shares.
- Government/Legal Shares will be converted into A Shares.
- This is about 2/3 of the total capitalization of all SOEs
- This will threaten private investors with a large dilution of their holdings.
- The Government is aware of this problem and has started a conversion program with 100 SOEs.
- The Government will compensate each A share investor by giving each investor 3 shares of the State-owned stock to the investor for every 10 shares of stock held by the investor.

Stock Exchanges

There are 3 stock exchanges in China: Hong Kong, Shanghai, and Shenzhen.

- Hong Kong and Shanghai are the main markets.
- Hong Kong Market Capitalization is about $850 billion while Shanghai is about $125 billion.
- Approximately $300 billion of Chinese companies are listed outside of mainland China, mostly in Hong Kong, compared to the $125 billion of shares listed in China.
- There is some debate whether the Hong Kong stock market will merge into the Shanghai stock exchange or vice versa.
    - It is clear that the CRSC would like to merge Hong Kong in the Shanghai Stock Exchange
    - But, Hong Kong's dominance with foreign investors makes this the better economic choice.
- Most private enterprises in China (those not controlled by the State) list their shares either in Hong Kong (H shares) or overseas on the NYSE, London Stock Exchange, Deutsche Bourse, etc. (N Shares).

Qualified Foreign Institutional Investors

- In order to open up its domestic stock exchanges to foreign investment, the Chinese government now allows QFIIs to purchase A shares.
- A QFII must meet the following thresholds:
    - Must have at least $10 billion in AUM
    - Must have a 5 year investment history
  - No more than 10% of A shares can be owned by a single QFII
  - No more than 20% of A shares can be owned by all QFIIs

Conclusions

- China is still an **emerging** country.
- Capitalism is the major motivating factor in China.
- But, its internal stock markets are nascent.
- Corporate governance issues abound with the multitude of Share classes.

- While the CRSC has made a major push to modernize the Shanghai Stock Exchange, Hong Kong and foreign markets remain the Listing Exchanges of choice.
- China has begun to open up its local A share markets with QFIIs.
- But the CRSC has a major reform program to accomplish as the over 1,000 SOES convert their un-listed State-owned shares to public ownership.

Global Fixed Income Treatment of China

CalPERS' Foreign Debt Policy allows both the internally managed dollar-denominated sovereign portfolio and the externally managed nondollar fixed income portfolios to hold global (i.e., "Yankee" and "euro") bonds issued in major currencies in major markets by China's national government and by the government of Hong Kong SAR. Such global debt qualifies by virtue of those governments' investment-grade agency ratings, with China rated A2 by Moody's, A- by S&P, and A by Fitch, while Hong Kong SAR is rated more highly, at A1 by Moody's, AA- by S&P, and AA- by Fitch. The internally managed sovereign portfolio holds Hong Kong SAR global bonds having a market value of $10.2 million, but no China bonds. The externally managed nondollar portfolios hold neither Hong Kong's nor China's global bonds.

Since China does not have a fully convertible currency and is not included in the Lehman Global Aggregate, CalPERS' Foreign Debt Policy does not allow the externally managed nondollar portfolios to hold the local currency debt of the national government of China or any debt, global or local, of Chinese corporations. However, since Hong Kong has its own fully convertible local currency and is included in the Lehman Global Aggregate, the externally managed nondollar portfolios may hold debt issued by the government of Hong Kong SAR in local currency, as well as both the global bonds and local-currency debt of Hong Kong corporations that are rated investment grade, but the portfolios do not hold these types of Hong Kong debt currently.

China has about $800 billion worth of reserves of major currencies and gold, many times the government's roughly $35 billion of debt denominated in major currencies. These reserves make default on that debt very unlikely. While this low probability of default is a big plus for China's dollar-denominated global bonds, the spread of their yields over U.S. treasuries is unattractively narrower than spreads on global debt of Hong Kong. Meanwhile, Hong Kong also has abundant reserves and offers closely similar regional economic exposure with a higher credit rating—owing to its much more advanced economic and political development. For these reasons, the internally managed dollar-denominated sovereign portfolio holds Hong Kong's bonds rather than China's.

Private Equity Perspective on China

The opportunity for investment in China is drawing increasing attention in the private equity industry. The country's enormous economic growth and transformation from a centrally-planned economy to a market-based economy has attracted a number of US and European investors.

For the first time, foreign investors are able to acquire controlling stakes in Chinese companies. This is being driven by the government's desire to sell (or privatize) State Owned Enterprises (SOE's).

Some of CalPERS' key investment partners such as Carlyle and TPG Newbridge have completed pioneering transactions in the country. For example, Carlyle recently completed the first ever leveraged buyout in China with its acquisition of a major construction machinery company. And, TPG Newbridge has acquired a stake in the largest PC manufacturing company in China and was one of the first foreigners to invest in a major Chinese bank.

However, completing transactions, particularly control-oriented transactions, is extremely complex in China. Issues include complex deal structures, difficult due diligence and corporate governance issues, and multiple layers of government involvement. One of the other key issues for investors in China has been the difficulty in exiting investments, primarily due to the lack of a deep, liquid domestic capital market. These issues, among many others, are examples of some of the risks inherent in investing in private equity in China.

Partner selection has always been the key to successful private equity investing. More so than anywhere else in the world, this will be the case in China. The ideal partner should have a strong local presence and be well connected in both the business and government communities. In addition, the partner should possess all of the skills necessary to evaluate, structure, monitor, and exit private equity investments.

<u>Summary for private equity</u>

- China is attracting significant attention and interest in the private equity arena.
- The government is now allowing foreigners to buy control of Chinese companies.
- Completing transactions is highly complex and involve substantial risk.
- Exit options are typically limited to foreign capital markets and strategic (multinational) acquirers.
- As China continues its emergence, significant investment opportunities should be expected (i.e., privatization of SOE's, growth financings, etc.).
- Investors need to thoroughly understand the risks and ensure expected returns are commensurate with those risks.

- Selecting the right private equity partners is paramount to maximizing opportunities for success in China.

Real Estate

The Chinese economy has undergone a major metamorphosis, moving from a centrally planned structure towards more influence from free market forces. Economic changes that have occurred include being a global manufacture of textiles, privatization of state owned enterprises, establishment of Special Economic Zones with tax incentives, lifting of price controls and the abolishment of credit quotas in the banking sector. These structural economic changes have resulted in developing financial markets, growing middle class, a rise in disposable income and an increase demand for durable and non-durable consumer goods.

These conditions have resulted in tremendous real estate investment opportunities in the residential, multi-family, industrial and office property types. The Chinese government has implemented property right regulations to improve market transparency and grant private ownership of real estate. In addition, the government has enhanced housing reforms to mitigate rapid appreciation in property values resulting in higher affordability of home ownership. During our visit several themes applicable to business in China certainly came up:

- China has regulations in place to protect workers and investors in the country – unfortunately, due to the size of the Cities and the Country as a whole, these regulations are sometimes poorly enforced and;

- While the government is very open to changing regulations to enhance businesses that promote jobs and economic development, the government also can rescind or change existing regulations at will with no “grandfathering”.

During our visit in Beijing, the Hines team took us on a tour of their luxury 174 unit rental project, “Embassy House” which is completed and over 90% occupied. I believe everyone was impressed not only with the quality of the project, but with the quality of and professionalism of the property management on the project. The aforementioned group also visited Hines new 900+ unit condominium project “Park Avenue” where Hines made available its entire senior construction staff construction, as well as, their general contractor on the project.

In summary, while the residential markets have slowed due to the government trying to control speculation, quality projects that are priced to their target market are achieving success. It is imperative the partner and general contractor be well versed in local and national regulations pertaining to their proposed type development: worker rights issues can be guarded at the project level….who we do business with is the key.

Legal and Regulatory Environment

Historically, the law is less important in shaping behavior than other societal mores. Social harmony, the ability to mediate, and obtaining consensus are more influential arbiters. Nevertheless, since 1978 China has initiated an ambitious program to reform its legal and accounting systems. These efforts, initiated by the central government, have lead to adoption of a fairly comprehensive and modern body of law. Private enterprise is now recognized through the adoption of these laws. However, not all of these laws are consistently followed. Local officials continue to favor their own interests over national policy. A common theme we heard was, “good laws, lax enforcement.”

China is, of course, a communist country. Before 1978, the government was the sole owner of all economic enterprises. Thus, there is an identifiable political risk of returning to a controlled economy through nationalization. However, this risk seems remote for the foreseeable future. Every indication is that the central government is committed to economic growth through a market-based economy. Perhaps the best indication is the level of foreign investment in major state enterprises such as the central banks.[1] The communist government continues to play a strong role through economic policy, company ownership, and regulatory control.

The following summarizes highlights:

- Court System. Despite changes in the laws, the court system remains unreliable. Judges typically are not lawyers; oftentimes they are former military or political officials. Ex parte contacts (i.e., communications between one or other of the parties and the judge outside of court) are common, even expected. Decisions are not consistent from region to region and judges typically favor local litigants over others – particularly foreigners. Corruption continues to be a problem. There is no tradition of legal institutions to lend credibility to the court system. The central government is very concerned about the court system and reforms are on the horizon, but they have not yet had a significant impact. For these reasons, foreign investors typically negotiate binding arbitration agreements which require proceedings to be held in Hong Kong, London or New York.

- Contracts. China has adopted a body of statutes that reflects modern contracts law; however, parties cannot rely on contractual provisions to resolve disputes. Important to institutional investors, the law recognizes limited liability of passive investors through limited liability companies or joint

[1] For example, Bank of America committed $2.5 billion to the purchase of a 9% ownership share of China Construction Bank (CCB) – the third-largest bank in China. Reportedly, it also purchased another $500 million in shares as part of the initial public offering of CCB this month. Even after the stock offering, however, the Chinese government will continue to own 62% of the company and will continue to control the Board of Directors.

stock companies. Foreigners can make direct investments if they meet certain conditions; however, their level of ownership is limited by law. Several persons we spoke with emphasized the importance of relationships over contract terms. Disputes between business partners are typically resolved through negotiation and not through litigation.

- Real Property. Legal title to all real property in China remains with the state. The government allows private parties to obtain land-use permits for a specific number of years, depending upon the type of usage. Residential permits, for example, are for seventy years. Land-use rights are recognized as property interests.

- Labor Laws. China has strong laws designed to protect workers. For example, an employee generally may not be fired (without cause) if he or she has worked at the same company for ten years, or is within ten years of retirement. But many of these laws are not enforced. Industrial accidents are common and worker safety continues to be an issue. According to newspaper reports, China accounted for 80 percent of the world's fatalities by mining accidents in 2004. The central government recognizes this problem and has adopted policies to heighten safety standards. However, enforcement by local officials is often lax because the violators are often large state-owned enterprises (see below).

- Labor Unions. There are also laws protecting workers' rights to organize but, in reality, these appear limited. There is only one lawful labor union in China – the All China Federation of Trade Unions (ACFTU) and it is subordinate to the Communist Party. The ACFTU occupies an unusual position in pursuit of its goal of increased production – it represents both labor and management. Thus, it cannot effectively represent workers in disputes with management over wages, hours or other working conditions. This has lead to labor unrest, with strikes and other disruptions on the rise. The central government has taken steps to respond to these incidents, but not through the ACFTU. There is some indication that local officials of the ACFTU are more interested in representing the rights of workers, but it is unclear if the top leadership will respond.

- State-Owned Enterprises. Despite economic reforms, the state still owns a large number of businesses; these are called State-Owned Enterprises (SOEs). Estimates vary, but approximately a third of the Gross Domestic Product was generated by SOEs in 2003. Typically, SOEs are owned by the local governments. They are an important source of jobs – and therefore stability – in the region. While the central government is taking steps to "privatize" many of these firms, these efforts may be resisted by local officials. For companies that are publicly listed on one of the two stock exchanges in mainland China, the current plan is to allow the conversion of non-tradable state shares ("Legal Person" shares) to tradable shares. Typically, a portion of the Legal Person shares (30%) is received by non-state investors already holding shares and the remainder go to the state. All converted shares (including those owned by the state) could be traded on the appropriate exchange after a lock-up period. For each company, the conversion plan must be approved by all shareholders. According to officials, most of the companies publicly traded on the Shanghai stock exchange will complete this process by the end of next year.

V. STRATEGIC PLAN:

Goal IX: Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

This item provides information to Investment Committee members a perspective on the economic growth of China.

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Real Estate

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